

Testimony on “Perspectives on Money Market Mutual Fund Reforms”

by

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Before the Committee on Banking, Housing, and Urban Affairs of the United States Senate

June 21, 2012

Chairman Johnson, Ranking Member Shelby, and members of the Committee:

Thank you for the opportunity to testify about the Securities and Exchange Commission’s regulation of money market funds.¹ The risks posed by money market funds to the financial system are part of the important unfinished business from the financial crisis of 2008. One of the seminal events of that crisis occurred in September, after Lehman Brothers filed for bankruptcy and the Reserve Primary Fund “broke the buck,” triggering a run on money market funds and freezing the short-term credit markets. Although the Commission took steps in 2010 to make money market funds more resilient, they still remain susceptible today to investor runs with potential systemic impacts on the financial system, as occurred during the financial crisis just four years ago. Unless money market fund regulation is reformed, taxpayers and markets will continue to be at risk that a money market fund can “break the buck” and transform a moderate financial shock into a destabilizing run. In such a scenario, policymakers would again be left with two unacceptable choices: a bailout or a crisis.

¹ The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the full Commission.

My testimony today will discuss the history of money market funds, the remaining systemic risk they pose to the financial system even after the 2010 reforms, and the need for further reforms to protect investors, taxpayers and the broader financial system.

Background

Money market funds are important and popular investment products for millions of investors. They facilitate efficient cash management for both retail and institutional investors, who use them for everything from making mortgage payments and paying college tuition bills to the short-term investment of cash received through business operations until needed to fund payrolls or pay tax withholding. Money market funds bring together investors seeking low-risk, highly-liquid investments and borrowers seeking short-term funding. With nearly \$2.5 trillion in assets under management, money market funds are important and, in some cases, substantial providers of credit to businesses, financial institutions, and some municipalities who use this financing for working capital needs and to otherwise fund their day-to-day businesses activities.

Money market funds are mutual funds. Like other mutual funds, they are regulated under the Investment Company Act of 1940. In addition, money market funds must comply with Investment Company Act rule 2a-7, which exempts money market funds from several provisions of the Investment Company Act – most notably the valuation requirements – to permit them to maintain stable net asset values per share (“NAV”), typically \$1.00. Under this special rule, money market funds, unlike traditional mutual funds, can maintain a stable value generally by using an “amortized cost” accounting convention, rather than market values, when valuing the funds’ assets and pricing their shares. The rule essentially permits a money market fund to

“round” its share price to \$1.00, but requires a money market fund to re-price its shares, if the mark-to-market per-share value of its assets falls more than one-half of one percent (below \$0.9950), an event colloquially known as “breaking the buck.”

The Commission adopted rule 2a-7 in 1983 with the understanding that the value of the short-term instruments in which the funds invest would rarely fluctuate enough to cause the market-based value of the fund’s shares to deviate materially from a fund’s typical \$1.00 stable value. Rule 2a-7 limits money market funds’ investments to short-term, high-quality securities for this very purpose.

Despite these risk-limiting provisions, money market funds can – and do – lose value. When, despite these risk-limiting provisions, money market fund assets have lost value, fund “sponsors” (the asset managers – and their corporate parents – who offer and manage these funds) have used their own capital to absorb losses or protect their funds from breaking the buck. Based on an SEC staff review, sponsors have voluntarily provided support to money market funds on more than 300 occasions since they were first offered in the 1970s.² Some of the credit events that led to the need for sponsor support include the default of Integrated Resources commercial paper in 1989, the default of Mortgage & Realty Trust and MNC Financial Corp commercial paper in 1990; the seizure by state insurance regulators of Mutual Benefit Life Insurance (a put provider for some money market fund instruments); the bankruptcy of Orange County in 1994; the downgrade and eventual administrative supervision by state insurance

² Forms of sponsor support include purchasing defaulted or devalued securities out of a fund at par/amortized cost, providing a capital support agreement for the fund, and sponsor-purchased letters of credit for the fund. Sponsor support does not include a sponsor taking an ownership interest in (i.e., purchasing shares of) a money market fund.

regulators of American General Life Insurance Co in 1999; the default of Pacific Gas & Electric and Southern California Edison Co. commercial paper in 2001; and investments in SIVs, Lehman Brothers, AIG and other financial sector debt securities in 2007-2008. In part because of voluntary sponsor support, until 2008, only one small money market fund ever broke the buck, and in that case only a small number of institutional investors were affected.

The amount of assets in money market funds has grown substantially, and grew particularly rapidly during recent years from under \$100 million in 1990 to almost \$4 trillion just before the 2008 financial crisis. This growth was fueled largely by institutional investors, who were attracted to money market funds as apparently riskless investments paying yields above riskless rates. By 2008, more than two-thirds of money market fund assets came from institutional investors, which could wire large amounts of money in and out of their funds on a moment's notice. Some of these institutional assets were what are known in the business as "hot money"—assets that would be quickly redeemed if a problem arose, or even if a competing fund had higher yields. To compete for that money, some money market fund sponsors invested in new, riskier types of securities, such as "structured investment vehicles." The larger amount of assets in money market funds contributed to the likelihood that a credit event would create stresses on one or more funds, and that fund sponsors would not have access to a sufficient amount of capital to support the funds.

The 2008 Financial Crisis

Implicit sponsor support as a mechanism to maintain a stable \$1.00 share price increasingly came under strain as the size of money market funds grew into a several trillion

dollar industry. The Reserve Primary Fund broke the buck after it suffered losses its sponsor could not absorb. The Reserve Primary Fund, a \$62 billion money market fund, held \$785 million in Lehman Brothers debt on the day of Lehman Brothers' bankruptcy and immediately began experiencing a run—shareholders requested redemptions of approximately \$40 billion in just two days. The Reserve Primary Fund announced that it would re-price its shares below \$1.00, or break the buck.

Almost immediately, the run on the Reserve Primary Fund spread, first to the Reserve's family of money market funds, and then to other money market funds. Investors withdrew approximately \$300 billion (14%) from prime money market funds during the week of September 15, 2008. Money market funds met those redemption demands by selling portfolio securities into markets that were already under stress, depressing the securities' values and thus affecting the ability of funds holding the same securities to maintain a \$1.00 share price even if the other funds were not experiencing heavy redemptions. Money market funds began to hoard cash in order to meet redemptions and stopped rolling over existing positions in commercial paper and other debt issued by companies, financial institutions, and some municipalities. In the final two weeks of September 2008, money market funds reduced their holdings of commercial paper by \$200.3 billion, or 29%.

Money market funds were (and are) substantial participants in the short-term markets—in 2008 they held about 40% of outstanding commercial paper. The funds' retreat from those markets caused them to freeze. During the last two weeks in September 2008, companies that issued short-term debt were largely shut out of the credit markets. Cities and municipalities that

rely on short-term notes to pay for routine operations while waiting for tax revenues to be collected were forced to search for other financing. The few companies that retained access to short-term credit in the markets were forced to pay higher rates or accept extremely short-term—sometimes overnight—loans, or both. All of this occurred against the backdrop of a broader financial crisis, which was exacerbated by the growing credit crunch in the short-term markets.

More than 100 funds were bailed out by their sponsors during September 2008. But the fund sponsors were unable to stop the run, which ended only when the federal government intervened in an unprecedented manner. In September 2008, the Treasury Department temporarily guaranteed the \$1.00 share price of more than \$3 trillion in money market fund shares and the Board of Governors of the Federal Reserve System created facilities to support the short-term markets. These actions placed taxpayers directly at risk for losses in money market funds but eased the redemption pressures facing the funds and allowed the short-term markets to resume more normal operations. Because the federal government was forced to intervene we do not know what the full consequences of an unchecked run on money market funds would have been.

The experience of shareholders of the Reserve Primary Fund, however, is instructive about the impact of an unchecked run on investors. While some observe that shareholders in the Reserve Primary Fund ultimately “lost” only one penny per share, this ignores the very real harm that resulted from shareholders losing access to the liquidity that money market funds promise. They were left waiting for a court proceeding to resolve a host of legal issues before they could regain access to their funds. In the meantime, their ability to make mortgage payments, pay

employees' salaries and fund their businesses was substantially impaired, and Reserve Fund investors were left in a sea of uncertainty and confusion. Some of their money is still waiting to be distributed.

The next run might be even more difficult to stop, however, and the harm will not be limited to a discrete group of investors. The tools that were used to stop the run on money market funds in 2008 are either no longer available or unlikely to be effective in preventing a similar run today. In September 2008, the Treasury Department used the Exchange Stabilization Fund to fund the guarantee program, but in October 2008 Congress specifically prohibited the use of this fund again to guarantee money market fund shares.³ The Federal Reserve Board's Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF"), through which credit was extended to U.S. banks and bank holding companies to finance purchases of high-quality asset backed commercial paper ("ABCP") from money market funds, expired on February 1, 2010. Given the significant decline in money market investments in ABCP since 2008, reopening the AMLF would provide little benefit to money market funds today. For example, ABCP investments accounted for over 20% of Moody's-rated U.S. prime money market fund assets at the end of August 2008, but accounted for less than 10% of those assets by the end of August 2011.

³ See Emergency Economic Stabilization Act of 2008, Public Law 110-343, 122 Stat. 3765 § 131 ("The Secretary is prohibited from using the Exchange Stabilization Fund for the establishment of any future guaranty programs for the United States money market mutual fund industry.").

The 2010 Reforms

Shortly after I joined the Commission in 2009, I asked the Commission's staff to prepare rulemaking designed to address concerns about money market funds revealed by the 2007-2008 crisis. The staff, with assistance from a report prepared by the money market fund industry, quickly identified some immediate reforms that would make money market funds more resilient. I am proud of this initial reform effort, but it is important to recognize what it did and did not do. The initial reforms, adopted and implemented in 2010, were designed to reduce the risks of money market funds' portfolios by reducing maturities; improving credit standards; and, for the first time, mandating liquidity requirements so that money market funds could better meet redemption demands. The new reforms also required money market funds to report comprehensive portfolio and "shadow NAV" information to the Commission and the public.

The 2010 rules made money market funds more resilient in the face of redemptions by requiring them to increase the liquidity of their portfolios. But the amendments did not (1) change the incentives of shareholders to redeem if they fear that the fund will experience losses; (2) fundamentally change the dynamics of a run, which, once started, will quickly burn through the additional fund liquidity; (3) prevent early redeeming, often institutional investors from shifting losses to remaining, often retail investors or (4) enable money market funds to withstand a "credit event" or the loss in value of a security held by a money market fund, precisely what triggered the run on the Reserve Primary Fund.

That money market funds were able to meet redemptions last summer when the markets were under stress suggests the 2010 reforms have helped address the risks they were designed to

address. However, the reforms were not designed to address the structural features of money market funds that make them susceptible to runs, and the heavy redemptions of 2011 were (1) substantially less than in 2008, (2) made over a longer period of time, and (3) not accompanied by losses in fund portfolios. During the *three-week* period beginning June 14, 2011, investors withdrew approximately \$100 billion from prime money market funds. In contrast, during the 2008 financial crisis, investors withdrew over \$300 billion from prime money market funds *in a few days*. These are significant differences. If there had been real credit losses last summer, the level of redemptions in some funds could very well have forced a money market fund or funds to break the buck, leading to the type of destabilizing run experienced in 2008.

The events of last summer demonstrate that money market fund shareholders continue today to be prone to engage in heavy redemptions if they fear losses may be imminent. About 6% of prime fund assets were redeemed during a three-week period beginning June 14, 2011, and one fund lost 23% of its assets during that period even though the funds involved had not experienced any losses. The incentive to run clearly remains in place notwithstanding the 2010 reforms.

Susceptibility to Runs

Money market funds are vulnerable to runs because shareholders have an incentive to redeem their shares before others do when there is a perception that the fund might suffer a loss. Several features of money market funds, their sponsors, and their investors contribute to this incentive.

- Misplaced Expectations. The stable \$1.00 share price has fostered an expectation of safety, although money market funds are subject to credit, interest-rate and liquidity risk. Recurrent sponsor support has taught investors to look beyond disclosures that these investments are not guaranteed and can lose value. As a result, when a fund breaks a dollar, investors lose confidence and rush to redeem. Not only did large numbers of investors redeem their shares from The Reserve Primary Fund that held Lehman Brothers commercial paper, they also redeemed from other Reserve money market funds that held no Lehman Brothers paper, including a government fund.
- First Mover Advantages. Investors have an incentive to redeem at the first sign of problems in a money market fund. An early redeeming shareholder will receive \$1.00 for each share redeemed even if the fund has experienced a loss and the market value of the shares will be worth less (e.g., \$0.998). By taking more than their pro rata share of the assets, these redemptions at \$1.00 per share concentrate losses in the remaining shareholders of a fund that is now smaller.⁴ As a result a small credit loss in a portfolio security, if accompanied by sufficient redemptions, can threaten the fund with having to break the buck.

Moreover, early redeemers tend to be institutional investors with substantial amounts at stake who can commit resources to watch their investments carefully and who have

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Assume, for example, a fund with 1,000 shares outstanding with two shareholders, A and B, each of which owns 500 shares. An issuer of a security held by the fund defaults, resulting in a 25 basis point loss for the fund—a significant loss, but not one that is large enough to force the fund to break the buck. Shareholder A, aware of a problem and unsure of what shareholder B will do, redeems all of his shares and receives \$1.00 per share even though the shares of the fund have a market value of \$0.998. The fund now has only 500 shares outstanding, but instead of a 25 basis point loss has a 50 basis point loss and will have broken the buck. Shareholder A has effectively shifted his losses to Shareholder B.

access to technology to redeem quickly. This can provide an advantage over retail investors who are not able to monitor the fund's portfolio as closely. As a consequence, a run on a fund will result in a wealth transfer from retail investors (including small businesses) to institutional investors. This result is inconsistent with the precepts of the Investment Company Act, which is based on equal treatment of shareholders.

- Mismatch of Assets and Liabilities. Finally, money market funds offer shares that are redeemable upon demand, but invest in short-term securities that are less liquid. If all or many investors redeem at the same time, the fund will be forced to sell securities at fire sale prices, causing the fund to break a dollar, but also depressing prevailing market prices and thereby placing pressure on the ability of other funds to maintain a stable net asset value. A run on one fund can therefore create stresses on other funds' ability to maintain a \$1.00 stable net asset value, prompting shareholder redemptions from those funds and instigating a pernicious cycle building quickly towards a more generalized run on money market funds.

Given the role money market funds play in providing short-term funding to companies in the short-term markets, a run presents not simply an investment risk to the fund's shareholders, but significant systemic risk. No one can predict what will cause the next crisis, or what will cause the next money market fund to break the buck. But we all know unexpected events will happen in the future. If that stress affects a money market fund whose sponsor is unable or unwilling to bail it out, it could lead to the next destabilizing run. To be clear, I am not

suggesting that *any* fund breaking the buck *will* cause a destabilizing run on other money market funds—it is possible that an individual fund could have a credit event that is specific to it and not trigger a broad run—only that policymakers should recognize that the risk of a destabilizing run remains. Money market funds remain large, and continue to invest in securities subject to interest rate and credit risk. They continue, for example, to have considerable exposure to European banks, with, as of May 31, 2012, approximately 30% of prime fund assets invested in debt issued by banks based in Europe generally and approximately 14% of prime fund assets invested in debt issued by banks located in the Eurozone.

Additional Needed Reforms

The Commission staff currently is exploring a number of structural reforms, including two in particular that may be promising. The first option would require money market funds, like all other mutual funds, to buy and sell their shares based on the market value of the funds' assets. That is, to use “floating” net assets values. Such a proposal would allow for public comment on whether requiring money market funds to use floating NAVs would cause shareholders to become accustomed to fluctuations in the funds' share prices, and thus less likely to redeem en masse if they fear a loss is imminent, as they do today. It would also treat all investors more fairly in times of stress.

A second option would allow money market funds to maintain a stable value as they do today, but would require the funds to maintain a capital buffer to support the funds' stable values, possibly combined with limited restrictions or fees on redemptions. The capital buffer would not necessarily be big enough to absorb losses from all credit events. Instead, the buffer

would absorb the relatively small mark-to-market losses that occur in a fund's portfolio day to day, including when a fund is under stress. This would increase money market funds' ability to suffer losses without breaking the buck and would permit, for example, money market funds to sell some securities at a loss to meet redemptions during a crisis.

As described above, many money market funds effectively already rely on capital to maintain their stable values: hundreds of funds have required sponsor bailouts over the years to maintain their stable values. Requiring funds to maintain a buffer simply would make explicit the minimum amount of capital available to a fund. Today, in contrast, an investor must wonder whether a sponsor will have the capital to bailout its fund and, even if so, if the sponsor will choose to use it for a fund bailout.

Limits on redemptions could further enhance a money market fund's resiliency and better prepare it to handle a credit event. Restrictions on redemptions could be in several forms designed to require redeeming shareholders to bear the cost of their redemptions when liquidity is tight. Redemption restrictions could be designed to limit any impact on day-to-day transactions.

These ideas and others are the subject of continuing analysis and discussion at the Commission. If the Commission were to propose further reforms, there will, of course, be an opportunity for full public consideration and comment. In addition to a detailed release seeking comment on the likely effectiveness and impacts of the proposed reforms, the proposal will also include a discussion of their benefits, costs, and economic implications.

Conclusion

In closing, money market funds as currently structured pose a significant destabilizing risk to the financial system. While the Commission's 2010 reforms made meaningful improvements in the liquidity of money market funds, they remain susceptible to the risk of destabilizing runs. Thank you for the opportunity to testify on this important issue. I am happy to answer any questions that you might have.